

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Aqua Illinois, Inc.,)	
)	Docket No. 11-0436
General Increase in Water)	
and Sewer Rates)	

**REPLY BRIEF OF
THE PEOPLE OF THE STATE OF ILLINOIS**

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I. INTRODUCTION

The People of the State of Illinois (“People”) submit the following Reply Brief to address the arguments contained in the Initial Briefs of Aqua Illinois (“Aqua”) and the Staff of the Illinois Commerce Commission (“Staff”). The People will address incentive compensation, rate of return, and the consolidation and rate design requested by Aqua.

Consistent with their Initial Brief, the People request that the Commission (1) adopt a cost of capital that is no higher than that recommended by Staff witness Kight-Garlich; (2) adjust the allocation of increases among the customer classes to more closely align class revenue recovery with the classes’ actual cost of service; and (3) moderate the Company’s rate consolidation request so it is consistent with AG witness Scott Rubin’s proposal, which incorporates the principles of cost of service and gradualism and assures that no customer class bears an excessive and disproportionate rate increase.

II. AQUA HAS NOT JUSTIFIED ITS REQUEST FOR AN EXCESSIVE 10.9% RETURN ON EQUITY AND 8.91% OVERALL RATE OF RETURN.

Aqua cites the seminal *Bluefield* and *Hope Natural Gas* United States Supreme Court cases in arguing for its excessively high return on equity (“ROE”). Aqua Initial Br. at 13-14. Those cases hold that the regulators should set a return that is “reasonably sufficient.” *Hope Natural Gas*, however, and a more recent case, *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 109 S.Ct. 609 (1989), both stand for the more relevant proposition that regulatory commissions have broad latitude to set rates, and that the Courts only review the total impact of an Order. The *Duquesne* Court said:

We also acknowledged in that case [*Hope Natural Gas*] that all of the subsidiary aspects of valuation for rate-making purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some

degree. Today we reaffirm these teachings of *Hope Natural Gas*: ‘[I]t is not theory by the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry ...is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.’ [320 U.S.] at 602, 64 S.Ct., at 288.

488 U.S. at 310, 109 S.Ct. at 617. As demonstrated by both the Staff and the People’s Initial Briefs, the overall weighted cost of capital recommended by the Staff is both reasonable and well within the bounds of prior Commission decisions.

Aqua itemizes various criticisms of the Staff’s ROE calculation to support its view that the Staff ROE “represents an unexplained and unsubstantiated dramatic departure from historical, Commission-approved ROEs of 10.40% to 10.71% for other water and sewer utilities.” Aqua Initial Br. at 16. For example, Aqua takes issue with the Staff’s exercise of judgment in determining how to treat samples of water utility ROEs as opposed to samples of non-water utility company ROEs. This criticism merely represents a disagreement with the Staff, and does not support Aqua’s position that the Staff’s recommendation is a “dramatic departure” from prior Commission decisions. Further, the law is clear that a prior return on equity finding is not binding on a later decision. As the Court pointed out in the *Bluefield* case, “no proper rate can be established for all cases.” Rather, each case depends on the circumstances facing the utility at that particular time and place. *Bluefield Water Works v. West Virginia PSC*, 262 U.S. 679, 43 S.Ct. 675, 693 (1923). An order may not “properly be set aside merely because the Commission has on an earlier occasion reached another result; administrative authorities must be permitted, consistently with the obligations of due process, to adapt their rules and policies to the demands of changing circumstances.” *Permian Basin Area Rate Cases*, 390 U.S. 747, 784, 88 S. Ct. 1344, 1369 (1968).

In this case, Staff witness Kight-Garlich recommended an 8.13% overall cost of capital, with a 9.43% return on common equity. Staff Ex. 3.0 at 34. The 8.13% overall cost of capital *exceeds* the cost of capital approved by the Commission in the last Illinois American Water Company rate increase docket, where the Commission approved an overall cost of capital of 8.02%. Order at 113, ICC Docket 09-0319 (April 13, 2010). Similarly, it exceeds by 34 basis points the 7.79% overall cost of capital in the Utilities Inc. request for water and sewer rate increases in Dockets 09-0548/0549. Order at 26 (Sept. 9, 2010) and it exceeds the 7.71% overall cost of capital in the more recent Utilities Inc. request for water and sewer rate increases in Dockets 11-0059/0241/0242, Order at 25 (Nov. 8, 2011). The Commission should reject Aqua's premise that the Staff recommendation is somehow unreasonably low or inconsistent with prior orders.

In setting the revenue requirement, the Commission applies the overall cost of capital to an approved rate base. While the Commission will consider the analyses Aqua discusses at length in its Initial Brief at pages 14-20, the ultimate cost of capital reflects the capital structure of the utility as well as all of the cost components. Staff witness Kight-Garlich testified that capital structure affects the value of a firm and, therefore, its cost of capital, to the extent it affects the expected level of cash flows that accrue to outside parties (i.e., other than debt and stock holders). Staff Ex. 3.0 at 5. Indeed, the overall cost of capital applied to rate base is a calculation based on the weighted components of the capital structure, where higher percentages of expensive equity result in a higher overall cost of capital. See, e.g., Aqua Ex. 5.0 at 11; Staff Ex. 3.0, Sch. 3.01. In determining whether the recommended cost of capital is an unreasonable deviation from past practice or orders, the Commission should assess the overall cost of capital rather than its piece parts.

As shown above, it is clear that the overall cost of capital recommended by the Staff is in fact *higher* than the overall cost of capital allowed other water utilities in Illinois, notwithstanding that interest rates for long term treasury bills have declined. Staff Cross Ex. 3. In addition, the ROE demanded by the Company is substantially higher than the highest ROE reported in the Staff water ROE sample. The DCF results for the Staff water ROE sample range from 7.06% to 9.46%, Staff Ex. 3.0, Sch. 3.09, yet Aqua suggests that an ROE of 10.9% is reasonable, while an ROE of 9.43% is somehow outrageous. Finally, in the Stipulation increasing the ROE above the Staff witness' recommendation in Docket 10-0194, the Stipulation provided that both Aqua and the Staff could present alternative arguments on all issues in future Aqua rate cases. Aqua Staff Ex. 1, at page 2, Docket 10-0194 (filed on e-docket August 26, 2010). The Staff is not obligated to increase its witness's recommendation in this docket simply because the Staff entered into a settlement with the Company in a prior docket. See Aqua Initial Br. at 18.

Ultimately, the Commission should consider the overall cost of capital rather than Aqua's piece part approach which ignores the effect of capital structure on the overall cost of capital and which posits a "dramatic departure" from prior orders. As the Court stated in *Hope Natural Gas* and *Duquesne*, an order must be "viewed in its entirety" and "[i]t is not theory, but the impact of the rate order which counts." 320 U.S. at 602; 488 U.S. at 314-316. The overall cost of capital recommended by Staff is in fact higher, not lower, than the overall cost of capital allowed in recent water and sewer rate increase requests. Aqua's arguments in support of an increase of its cost of capital to 8.91% should be rejected.

III. AQUA’S TEPID AND SUPERFICIAL ARGUMENTS FOR ITS RADICAL CONSOLIDATION REQUEST BELIE ITS LACK OF JUSTIFICATION AND ITS BURDENSOME IMPACT ON CONSUMERS.

Aqua argues that it will be easier for it to maintain records and modify rates if all of the rate divisions – other than the largest division, Kankakee – are consolidated all at once in this docket. It suggests that immediate consolidation “is unlikely to create an unbearable rate shock to customers in the smaller divisions and therefore, it should be adopted.” Aqua Initial Br. at 21. Aqua neither defines nor illustrates what it means by rate shock or by “unbearable rate shock,” nor does it address its proposal to recover a 22.74% revenue increase through revenue increases up to triple digits (Fairhaven: 120%, Ivanhoe: 203.8%, Ravenna: 232.8%). Aqua also fails to address the mismatch between its COSS and its proposals, despite the Commission’s interest in designing rates to reflect cost of service. See Order at 20-21, ICC Docket 10-0517 (March 15, 2011) (any movement toward consolidation “must also consider the Commission’s efforts to foster cost-based rates.”).

It is understandable that the Company would want to change rates so that they are all the same, and so it is easier for the Company to maintain its books and obtain future rate increases. See Aqua Initial Br. at 20-22. However, these benefits to the Company should not be delivered at the cost of triple digit increases to some consumers. Increases of that magnitude are “rate shock” and further, are unnecessary. The Commission should question why Aqua chose to *exclude* the one division that has more customers than all of the divisions subject to this case (i.e. the Kankakee Division), when one of the asserted benefits of consolidation is to achieve economies of scale and “protect[] customers against significant rate shock and address[] smaller system viability issues.” Aqua Initial Br. at 21.

Perhaps Aqua did not defend its sweeping consolidation proposal because it has already recognized how extreme it is, and its own witness testified that the more gradual Staff approach

is acceptable to him. Aqua Ex. 16.0 at 4. Although Staff's Initial Brief describes the consolidation it supports, it does not explain the reasons underlying the Staff recommendation, whether the Staff recommendation is consistent with the results of the COSS, or the rate impacts that would result.

The People agree with portions of the Staff recommendation, and believe that the Staff recommendation can be harmonized with the People's request to reflect both cost of service and gradualism principles. Specifically, both the Staff and the People include **Ravenna, Hawthorne Woods** and **Vermillion** in a single district. Staff also suggests including **Oak Run** in this district, with the result that Oak Run consumers would see their water rates decrease by 13.32%. Because Oak Run's rates are already the highest among the Aqua divisions, and the Company would have Oak Run produce more than its cost of service, consolidation that will lead to a rate reduction for that division is appropriate. See Staff Ex. 9.0R at 14, Table 9.5; People's Initial Br. at 5 (showing COSS results).

Staff's proposal includes the **Candlewick** Division with the seven other districts. In contrast with Oak Run, consolidation for Candlewick would raise prices for these consumers despite the fact that the COSS shows that they are entitled to a rate decrease, and that they are being asked to pay significantly more than their cost of service. See id. (stand-alone cost of service is \$1.0 million but they are being asked to produce \$1.35 million). Consolidation would harm Candlewick consumers and is inconsistent with cost of service principles. The Commission should reject consolidation of Candlewick at this time. Over time the cost of service of Candlewick and the other divisions should converge, as the Commission noted in the Ameren consolidation docket, and it can be consolidated at a time when consumers will not be "losers" due to consolidation. See Order at 20-21, ICC Docket 10-0517 (March 15, 2011) (over

time “the costs of serving customers in the three rate zones will move closer together ... [and] may be considered ‘close enough,’ all things considered, and ready for consolidation.”)

Of the remaining four divisions, **Ivanhoe** should be removed from the large consolidation group. The monthly bill for a consumer in the district using 5,000 gallons per month would more than double if this division were consolidated, increasing by 130.55%. Staff Ex. 9.0R at 14, Table 9.5. This result is contrary to cost of service principles, and would have this small division paying \$262,462 when its cost of service is only \$209,719. People’s Initial Br. at 5. The People recommend that Ivanhoe be consolidated with **University Park** which is another division with lower costs and lower rates. People’s Initial Br. at 12. This would temper the rate increase facing these consumers, and still move toward consolidation by establishing a consistent usage charge. This approach is superior to consolidating Ivanhoe with other, more costly divisions and would provide both Ivanhoe and University Park with the some benefits of consolidation.

Willowbrook and **Fairhaven** are not appropriate candidates for consolidation at this time. Both of these divisions would be asked to pay considerably more than their cost of service if they were consolidated.¹ This is unfair to consumers and contrary to cost of service principles. Further, neither the Company nor the Staff presented affirmative reasons for burdening these consumers with increases of 54.26% for Willowbrook and 61.83% for Fairhaven, solely to promote consolidation. See Staff Ex. 9.0R at 14, Table 9.5. Mr. Rubin’s recommendation is fairer to these consumers and would still produce the necessary revenue to meet Aqua’s revenue requirement, notwithstanding the substantial subsidy requested by Viscofan (which is in the Vermillion division). See People’s Initial Br. at 9-10.

¹ Willowbrook’s cost of service is \$989,474 but it is being asked to produce \$1,148,234. Fairhaven’s cost of service is only \$79,794, but it is being asked to produce \$118,241. People’s Initial Br. at 5.

The Commission should not allow this rapid consolidation simply because Aqua has asked for it. Illinois American Water Company (IAWC), the other major water company in the state, has moved much more slowly toward consolidation. Over the last 20 years it has consolidated many of its districts, but the Commission has not allowed consolidation of districts with disparate cost of service results. See Order at 9, ICC Docket 92-0116 (Feb. 9, 1993); Order at 27-29, ICC Docket 00-0340 (Feb. 15, 2001) (gradual movement to consolidated rate means that two districts remain separate, with some rate elements consolidated). Today, IAWC retains several smaller districts, including Chicago Metro, Pekin, and Lincoln. Order at App. C, E, F, ICC Docket 09-0319 (April 13, 2010). There is no reason to rush the process of consolidation in derogation of the principles of gradualism and cost of service. The Commission should only allow consolidation where the rate impact on consumers will not aggravate the already disproportionate burden residential customers are asked to bear due to the subsidy of Viscofan.

IV. AQUA’S TREATMENT OF VISCOFAN REPRESENTS SHORT TERM THINKING, WHICH THE COMMISSION SHOULD REJECT.

Aqua recommends a rate increase for Viscofan that is only 13.75%, which is significantly lower than the total revenue increase of 22.74% requested by the Company. Aqua Initial Br. at 34; Aqua Ex. 14.1, page 1. Although Aqua asserts that shifting cost recovery to other consumers “balances the interests of all parties,” it does not provide a comprehensive or long-term approach to the problem of rising water rates, the fact that industrial customers can obtain water at a lower cost, and that other customers (some in distant parts of the state) are being asked to make up the difference between a more economical cost of self-supply and Aqua’s rates.

AG witness Scott Rubin recognized the problem presented by an industrial customer that can self-supply at a lower cost than Aqua can offer. Rather than have Aqua proceed from case to case and improvise a solution, he suggested that Aqua enter into a contract to provide water

services over a longer term so that all parties – Viscofan, Aqua, and all other consumers – can predict the effect of keeping Viscofan on the system.

Regardless, however, of the size of subsidy the Commission may allow Aqua to charge other customers for Viscofan, the Commission should adopt Mr. Rubin’s proposal.

V. CONCLUSION

The People respectfully request that the Commission enter an order consistent with the recommendations contained in this Reply Brief and the People’s Initial Brief.

Respectfully Submitted,

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